TEACHERS’ RETIREMENT BOARD

AD HOC GOVERNANCE COMMITTEE

SUBJECT: Cortex Presentation	ITEM NUMBER: 5
	ATTACHMENT(S): 5
ACTION: X	DATE OF MEETING: April 2, 1998
INFORMATION: ____	PRESENTER: Chairperson

Mr. Tom Iannucci will present to the Committee the following document.

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM
GOVERNANCE DECISION-MAKING STRUCTURE
PRINCIPLES OF DELEGATION (PROPOSED)

Background & Purpose

As follow-up work to the recent Pension Fund Governance Review conducted at STRS, the Board agreed to undertake a process whereby it would revise the current decision-making structure in order to achieve greater clarity on the roles of the parties involved in the governance and management of STRS.

Rather than immediately setting out to draft new job descriptions for each party, STRS decided that it would first step back and identify the underlying principles of delegation that would guide the Board in this important task.

Establishing such principles will help to ensure that there is an underlying logic to the delegation of duties, and will reduce the potential for future Boards to make ad hoc and arbitrary changes to the decision-making structure without considering the underlying principles of delegation.

Once the principles have been approved, Cortex will work with the Board and management to develop a proposed new decision-making structure (in matrix format) and corresponding terms of reference. For reference, we have attached a Decision Matrix illustrating the current decision-making structure at STRS.

Below, for the Board's consideration, are proposed Guiding Principles of Delegation. We ask that you review them in preparation for a presentation and discussion at the April meeting of the Board. If you have any questions or comments before then, you are encouraged to contact Tom Iannucci of Cortex directly at (416) 967-9045.

When reviewing the principles, please note:

a) Following each principle is a brief description of the rationale behind it and, where, applicable an illustration of the concepts. The illustrations are not necessarily specific to STRS, but are offered for clarification only.

b) For purposes of this exercise, we define the decision-making structure to be the delegation of investment-related duties to each of the following bodies within STRS.
   - the Board
   - Investment Committee
   - Chief Executive Officer
   - Chief Investment Officer
   - General Consultant

c) Throughout this document we often refer to the terms policy and strategy. The meaning of these terms is often debated and common definitions have yet to be established. Therefore, for purposes of this document we have established the following definitions:

   Policy is defined as high level decisions that:
   i. have the most direct and meaningful impact on the long-term success of the Plan;
   ii. significantly affect the risk exposure of the Plan; or
   iii. significantly affect the cost structure of the organization.

   Policy decisions are generally long-term in nature and therefore should be made only infrequently. They should also generally be formulated so as to provide management with guidelines within which management will have flexibility to apply its own best judgment.

   Strategy comprises shorter-term decisions that are generally made more frequently. The purpose of strategy is to create additional value within the guidelines established by policy. Strategy decisions are generally expected to have relatively less impact on the success of the Plan than policy decisions.

PRINCIPLES OF DELEGATION

1. *In designing a decision-making structure one should strive to achieve clarity. This implies that roles and responsibilities should be distinct (e.g. no overlap of duties among parties). They should also be documented using clear and unambiguous language so that everyone can understand and agree to abide by them.*

   Rationale: Without sufficient clarity, the decision-making structure is likely to be misunderstood, or interpreted differently, by the various parties involved. This will, over time, reduce the effectiveness of the decision-making process, particularly where there is substantial turnover at the Board or management levels and, even more importantly, where the outcome of a decision proves to be unfavorable.

   Illustration: If a decision, such as the selection of a real estate investment, is shared between the Board and CIO, and the decision ultimately proves to be a poor one, it will not be immediately obvious who was responsible for the decision. A great deal of frustration may result as the organization attempts to assign blame for the decision rather than learn from the experience.

2. *A decision-making structure should be comprehensive in that it addresses all decisions or tasks that can have a meaningful impact on the success of the pension fund.*

   Rationale*:* If the decision-making structure fails to assign responsibility for an important task, then a vacuum is created and, inevitably, someone will step forward and assume responsibility for the task, even though he or she may not be the appropriate individual.

   Illustration: A pension fund by definition must have its assets allocated among asset classes. Therefore, if the Board does not explicitly retain responsibility for the long-term asset allocation decision, staff will by necessity have to make the allocation decision themselves, and they will rely on their own best judgment in doing so. Given that the asset allocation decision is such a crucial decision, it may not be appropriate for the Board to allow another party to make this decision.

3. *The design of the decision-making structure should recognize that there are certain basic tasks that the Board cannot delegate. The Board should retain all duties that pertain to defining the objectives of the Fund, defining the levels and types of risk to*

which the Fund is exposed, and delegating responsibility to appropriate individuals. The Board also cannot delegate the responsibility for monitoring the performance of the Fund, ensuring the safekeeping of the assets, and monitoring its own performance.

Rationale: By virtue of the Board having a trustee function, we would suggest that the above represents the minimum role the Board should play.

4. *The Board should delegate duties to those decision-making levels that are most likely to posses the requisite knowledge, experience, time availability, or independence to carry them out successfully.*

   Rationale: Many operational decisions, such as the selection of specific investments or investment managers, have relatively little impact on the financial performance of the total fund. However, they require highly specialized knowledge that can usually only be developed with years of experience. Furthermore, the decisions themselves are generally time consuming and labor intensive. The organization would be better served if the Board would delegate such decisions to staff and focus its efforts on higher-level policy issues that it is better positioned to address, and that have a greater impact on the Fund.

5. *The decision-making structure should be designed so that responsibility for high-level policy, strategy, and implementation issues are separated.*

   Rationale: There are five basic types of activity involved in the management of a pension fund:

   1. Setting broad policy
   2. Setting strategy
   3. Implementing policy and strategy (i.e. operations)
   4. Providing an objective external perspective
   5. Monitoring

   The above activities are distinct and require unique skills, perspectives, and time availability in order to carry them out successfully. Also, if a decision-making level attempts to undertake two or more of the activities, accountability can be severely weakened. Therefore, we have found that pension funds operate most effectively if the above activities, with the exception of monitoring, are separated and assigned to different levels of the organization.[1]

   Illustration: Table I below describes the process of selecting an investment manager, and demonstrates how a single task can in fact comprise policy, strategy, and implementation components.

[1] Monitoring is an activity that all levels of the organization can perform. However, different levels will typically monitor different issues, with different frequencies, and at varying levels of detail.

Table I

i.	Decide whether the Fund should pursue an active management approach and expose itself to the risks inherent in active management.	***Policy***
ii.	Decide which asset classes should be managed actively.	
iii.	Decide the performance targets and benchmarks.	
iv.	Decide whether the Fund should use internal or external managers.	
v.	Approve the process and criteria to be used in selecting investment managers.	
vi.	Decide upon the manager structure for each actively managed asset class; e.g. proportion internal versus external, number of managers, allocation to each manager, style, etc.	***Strategy***
vii.	Identify candidates that should initially be considered for selection?	***Implementation***
viii.	Assess the available candidates	
ix.	Select suitable candidates	
x.	Prepare mandates or portfolio guidelines	

One could argue that steps i. through v. are policy decisions and should be retained by the Board; step vi. is a strategic decision and should be delegated to senior management; and steps vii. through x. are implementation issues and should be delegated to management or operating staff.

Separating policy, strategy and implementation in the above manner helps to ensure clear accountability. For example, if the CIO were to direct investment managers to purchase specific securities, he would no longer legitimately be able to hold the manager accountable for investment results since the performance is now, at least partly, attributable to the CIO.

6. *In designing the decision-making structure, one should strive* ***to maximize the degree of objectivity*** *or independence with which all parties approach their role and*

responsibilities. Stated another way, the structure should ***minimize the existence of conflicts of interest*** *that might reduce the objectivity of any of the parties involved.*

Rationale: If this principle is not adhered to, a greater potential exists for individuals to put their own personal interests, or those of a particular constituency group, above the best interests of the Fund and the beneficiaries.

Illustration: Examples of provisions that will enhance objectivity and independence in the decision-making process include:

a) To the extent practicable, no party should assess its own performance. Parties may, however, have input into their own performance appraisals.
b) If any external consultant is expected to comment on the work or performance of internal staff, then staff should have little or no ability to influence the appointment or reappointment of the consultant.
c) If the external consultant is expected to provide an independent and objective perspective on the investment program, he or she should be in a position to comment on any aspect of the investment program without having a vested interest in the outcome.

7. *The decision-making structure should reflect a linear reporting structure. That is, the organization should consist of a single line of authority and accountability whereby each decision-making party reports upward ultimately through the CEO to the Board itself.*

Rationale*:* While there appear to be two completely distinct organizations within a pension plan, benefits administration and investments, they are in fact inextricably linked in two crucial ways:

a) Ultimately, the objective of the investment program is to ensure that sufficient funds exist to pay the benefits; therefore there exists a relationship between the assets and the benefits that must be carefully managed.
b) The two functions are linked organizationally in that organizational decisions made in either area may affect the other. For example, increasing the level of investment management performed in-house may reduce the budget available to hire benefit administration staff.

Given that the investment and benefit administration functions are in some ways linked, we would suggest that a single executive should be accountable for integrating both and making the compromises necessary to achieve the Plan's Mission. If the two functions are managed independently by different executives, then leadership for the organization as a whole is weakened, conflicts will inevitably arise, and the Board will have to adjudicate – which is arguably not a good use of the Board's time. Depending on the personalities of the executives involved, these conflicts may or may not manifest themselves to the Board, but nevertheless the effectiveness of a decision-making process should not rely solely on the personalities of the individuals involved. We suggest, therefore, that the decision-making structure should be designed to minimize the above problem and ensure that strong leadership is in place for the organization as a whole.

Illustration: Below is a practical example of how the above principle can be applied to the CEO-CIO relationship:

The CEO would be responsible for soliciting the CIO's views and endorsing his recommendations for Board approval on issues that fall into any of the following categories:

1. Affect the broad direction of the investment program. For example:
   a) Major changes in long-term asset allocation that widen the mismatch with plan liabilities or that diverge from the asset mix policies of peers.
   b) Switching from active to passive management or vice versa
2. Substantially increase the risk exposure of the Fund. For example:
   a) New risky asset classes
   b) Introduction of or exit from non-traditional asset classes
3. Have significant implications for the organization in terms of human resources, computer systems, public perception, fixed or variable costs; etc. For example:
   a) Increasing the amount of investment management performed in-house
   b) Increased use of active management

If the CEO endorses and the Board approves the CIO's recommendations, then the CIO is responsible for implementing the relevant policies or strategies; i.e. establishing manager structures, selecting appropriate investment managers, hiring investment staff, day-to-day monitoring, etc.

8. *The decision-making structure should consciously incorporate checks and balances to ensure that all decision-making parties feel a strong sense of accountability for their performance.*

Rationale: The essence of good governance is strong accountability. Given human nature, it would not be prudent to rely solely on the good will, dedication, and integrity of individuals, and trust that they will work to their potential and in the best interests of the Fund. Experience suggests, instead, that people tend to perform at higher levels if they know that they must account for their performance.

Examples of checks and balances that may be incorporated into the decision-making structure include:

a) Each decision-making level is clearly accountable to a more senior level for meeting its responsibilities.
b) Each decision-making level is responsible for monitoring that the policies or strategies it approves are being complied with.
c) Whenever a party delegates responsibility to another party, it must monitor to ensure that the responsibilities are in fact carried out, are consistent with policy guidelines, etc.
d) Whenever a party delegates a relatively risky task (e.g. selection of external investment managers) it should issue appropriate guidelines to be followed in carrying out the task.

9. *In designing a decision-making structure, the Board should strive to balance the need to maintain risk control with the need to encourage innovation and initiative among staff.*

Rationale: As part of its oversight function, the Board is expected to establish mechanisms to control and direct the activities of staff. Ultimately, however, the creation of value by the enterprise will depend upon the successful application of knowledge, expertise, and experience, most of which will always reside with staff. If value is to be created, therefore, the controls established by the Board should not be so constrictive that staff is unable to pursue opportunities for creating value.

Illustration: If the Board believes that it would like staff to create value through strategic asset allocation (i.e. market timing) then the decision-making structure could be designed as follows:

a) The Board is assigned responsibility for setting ranges around the long-term asset mix within which staff can have the flexibility to conduct market timing. In doing so, the Board effectively controls the risk that the Fund's performance will not differ significantly from what would have been achieved had the long-term asset allocation been maintained.

b) Staff is now free to apply its expertise and judgment to forecast the relative performance of different asset classes in order to add value.
c) The Board then monitors staff's performance to ensure that over the long run staff is in fact adding value through the market timing strategy.

10. The decision-making structure should include a mechanism that will enable it to continually evolve to best meet the needs of the organization.

Rationale. Unless a mechanism is established to review periodically the appropriateness of the decision-making structure, the structure will not be able to adapt to changing circumstances; the structure will eventually become obsolete, and all the effort that went into designing it in the first place will have been wasted.

Therefore the organization should establish a mechanism whereby the decision-making structure is periodically reviewed to ensure that it continues to be appropriate.

The following pages contain a decision matrix that illustrates STRS' current decision-making structure as described in existing committee charters, delegations of authority, positions descriptions, and contracts.

The decision matrix is provided to the Board as a reference tool only.